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No. 99-1693

In the Supreme Court of the United States

WILLIAM C. WITZEL AND GENE E. WITZEL,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Petitioner William C. Witzel was the sole shareholder in a Subchapter S corporation that obtained a discharge of indebtedness in a bankruptcy proceeding. That discharge *would* have been treated as an item of "[i]ncome from discharge of indebtedness" (26 U.S.C. 61(a)(12)) except that, because the discharge occurred during a bankruptcy proceeding, the item is expressly "not include[d] * * * in gross income" under 26 U.S.C. 108(a)(1)(A). The question presented in this case is whether the amount thus expressly excluded from "income" is nonetheless to be treated as if it *were* an item of "income" which, under 26 U.S.C. 1366(a)(1)(A), flows through to petitioner as the shareholder of the Subchapter S corporation, thereby increasing his basis in the stock of the corporation under 26 U.S.C. 1367(a)(1)(A), and thereby allowing him to deduct losses he previously was unable to deduct because he had exhausted his basis by prior deductions.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-6a) is reported at 200 F.3d 496. The memorandum opinion of the Tax Court (Pet. App. 8a-11a) is unofficially reported at 77 T.C.M. (CCH) 1487.

JURISDICTION

The judgment of the court of appeals was entered on January 18, 2000. The petition for a writ of certiorari was filed on April 17, 2000. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. a. During the 1993 taxable year, petitioner William C. Witzel was the sole shareholder of Water Products Co. of Illinois, Inc., a corporation that had elected to be taxed under the provisions of Subchapter S of the Internal Revenue Code, 26 U.S.C. 1361-1379. Pet. App. 9a. As this Court explained in *Bufferd* v. *Commissioner*, 506 U.S. 523, 525 (1993), Subchapter S of the Code implements "a pass-through system under which corporate income, losses, deductions, and credits are attributed to individual shareholders in a manner akin to the tax treatment of partnerships."

In 1991, Water Products filed a petition for relief under Chapter 11 of the Bankruptcy Code. Pet. App. 9a. In 1992, debts of that corporation totaling $5,404,323 were discharged by the bankruptcy court. *Ibid.* The discharge of these debts would have represented "[i]ncome from discharge of indebtedness" to the corporation (26 U.S.C. 61(a)(12)) but for the fact that the discharge occurred in a bankruptcy proceeding. Because the discharge occurred in a bankruptcy proceeding, it was expressly excluded from income under Section 108 of the Code, which specifies that "[g]ross income does not include any amount which * * * would be includible in gross income by reason of the discharge * * * of indebtedness of the taxpayer if * * * the discharge occurs in a title 11 case." 26 U.S.C. 108(a)(1)(A).

b. Although Section 108 of the Code thus specifies that discharge of indebtedness is *not* an item of income when the discharge occurs in a federal bankruptcy proceeding, petitioners claim that it should nonetheless be *treated* as if it were an item of income for purposes of

Sections 1366 and 1367 of the Code. Those provisions determine various aspects of the tax treatment of shareholders of a Subchapter S corporation. In particular, they specify that "items of income (including tax-exempt income), loss, deduction, or credit" pass through to the shareholders (26 U.S.C. 1366(a)(1)(A)), that the "items of income" that pass through to the shareholders increase the shareholders' basis in the stock of the Subchapter S corporation (26 U.S.C. 1367(a)(1)(A)), that the losses and deductions that pass through reduce the shareholders' stock basis (26 U.S.C. 1367(a)(2)(B)), and that distributions of earnings or assets of the corporation to the shareholders reduce their basis in the stock (26 U.S.C. 1367(a)(2)(A)). The basic concepts reflected in these provisions are: (i) that the income earned (or loss incurred) at the corporate level is treated as if it were earned (or lost) at the individual level; and (ii) that basis adjustments are made to avoid a double tax on those earnings or a double benefit from those losses.

A shareholder may deduct losses only to the extent that he has not previously recovered (through prior deductions) his basis in the stock. 26 U.S.C. 1366(d)(2). In this case, petitioner William Witzel had previously deducted losses representing his entire basis in the corporate stock. At the time the indebtedness of the Subchapter S corporation was discharged in 1992, petitioner would thus be allowed further deductions from the corporation's losses only if his basis in the stock of the corporation were somehow increased.[1]

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[1] The losses of the corporation incurred prior to and during 1992, which petitioner had been unable to deduct because he had exhausted his basis in the stock of the corporation, are described as "suspended" losses and are carried into future years. They may be

Petitioner asserts that the additional basis that would allow him to take further deductions from prior corporate losses can be found in the discharge of indebtedness "income" of the corporation in 1992. He contends that this discharge of indebtedness is an "item[] of income" (26 U.S.C. 1366(a)(1)(A)) which increases his basis in the corporate stock (under 26 U.S.C. 1367(a)(1)(A)) even though, for the reasons described above, Section 108(a) of the Code expressly states that this is "*not*" an item of income. Petitioner (and his wife on their joint return) thus claimed a loss deduction of $2,549,251 for the 1993 taxable year that reflected a carry forward of the losses incurred by Water Products in prior years. Pet. App. 10a.

The Commissioner of Internal Revenue determined that petitioner was not entitled to increase his stock basis by the discharge of indebtedness that was "not" an item of income under Section 108 of the Code. The Commissioner therefore disallowed the claimed deductions and asserted a deficiency in tax against petitioners for the 1993 taxable year. Pet. App. 22a-24a.

2. Petitioners filed a petition in Tax Court to contest the Commissioner's determination. Pet. App. 18a-21a. The Tax Court held that the discharge of indebtedness that occurred during the bankruptcy proceeding did not increase petitioner's basis in the corporate stock and that the asserted deductions were therefore properly denied. *Id.* at 8a-11a. In reaching that conclusion, the court relied on the reviewed Tax Court decision in *Nelson* v. *Commissioner*, 110 T.C. 114 (1998), aff'd, 182 F.3d 1152 (10th Cir. 1999), in which the court unanimously held that an amount excluded from an insolvent

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deducted in future years only if the shareholder acquires a basis in the stock to apply against them. 26 U.S.C. 1366(d)(2).

Subchapter S corporation's gross income under Section 108 does not increase a shareholder's basis in the corporate stock. Pet. App. 10a-11a.

3. The court of appeals affirmed. Pet. App. 1a-6a. The court noted that petitioners were seeking a double tax benefit from the amount excluded from Water Products' gross income—nonpayment of tax on the excluded amount plus use of that amount to obtain deductions for otherwise nondeductible suspended losses. *Id.* at 3a. The court concluded that it was "preferable" to interpret Section 108 to preclude that result. *Id.* at 4a.

DISCUSSION

This case presents the same question presented in *Gitlitz* v. *Commissioner*, No. 99-1295, in which this Court granted the petition for a writ of certiorari on May 1, 2000. The petition in this case should therefore be held and disposed of as appropriate in light of the Court's disposition of *Gitlitz*.[2]

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[2] We have provided herewith to petitioners a copy of the brief filed on behalf of the Commissioner in response to the petition for a writ of certiorari in the *Gitlitz* case.

CONCLUSION

The petition for a writ of certiorari should be held and disposed of as appropriate in light of the Court's disposition of *Gitlitz* v. *Commissioner*, No. 99-1295.

Respectfully submitted.

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